Highlights

- Q2 2017 GDP to grow at 5.1% (y.o.y.), 2017 GDP to grow at 5.1-5.3% (y.o.y.);
- Production growth is supported by broader base of industries;
- Domestic consumption to decelerate slightly due to purchase delay by households;
- 2017 inflation to be around 4.0% (y.o.y.)
- Investment and trade are the growth drivers for 2017.

Macroeconomic & Financial Sector Policy Research Group

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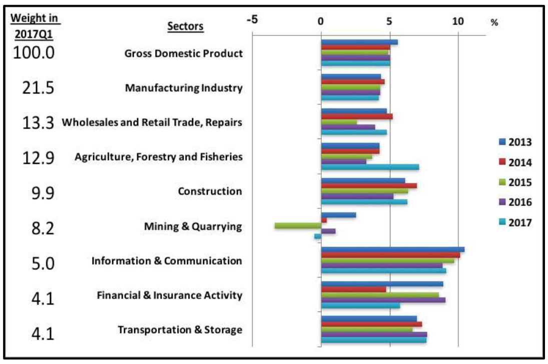
Stable GDP Growth with Broader Base

Indonesian GDP has been around its stable growth path which is more or less 5% per year in the last four years. Construction sector has been growing strongly since 2014. The ever-increasing investment in infrastructure projects would push this sector even higher. Information and Communication sector has dominated all of the sectors in GDP. The consumers have increasingly considered cellphone and internet as necessity instead of luxury. On the other hand, financial and insurance, transportation and storage are still championing the GDP growth rate.

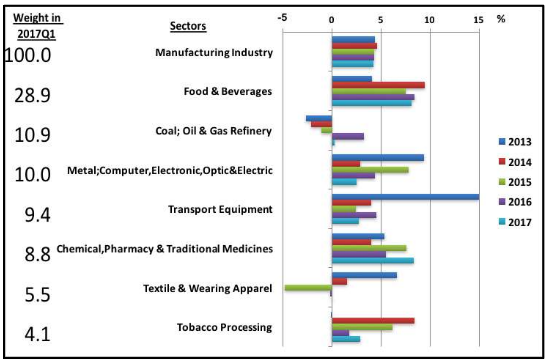
Manufacturing industry as the biggest sector in GDP has been sluggish overall (see Figure 1). Production of Food and Beverages is still leading this sector with strong growth of demand. Other than that, sub-sectors of manufacturing industry have had mixed dynamics.

Figure 1: Growth rate of GDP and the Main Industries, 2013-2017Q1



Source: CEIC

Figure 2: Growth rate of Manufacturing Sector and Its Major Sub-sectors, 2013-2017Q1

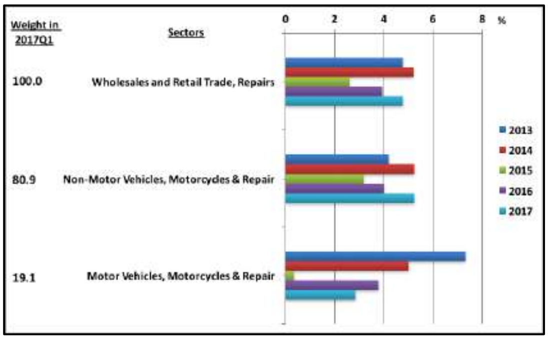


Source: CEIC

Passing its worst pace in 2015, Wholesale and Retail Trade significantly increases its pace in the last five quarters. Nevertheless, the domestic trade sector is still below the overall GDP growth, thanks to the decrease in production of motor vehicles due to weak sales. Strong growth in transportation and storage services (see Figure 1) might be the biggest reason as the online transportation and e-commerce activities surging in the last several years.

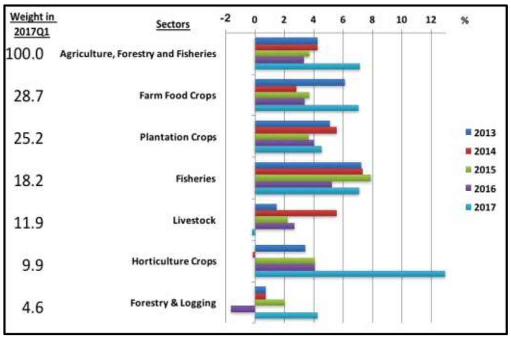
Agriculture, forestry and fisheries sector (Figure 4) has been helped by fisheries which still showing big potential for growth in the future. Slowly recovering price of CPO should help this sector in the near future.

Figure 3: Growth rate of Wholesale and Retail Trade and Its Sub-sectors, 2013-2017Q1



Source: CEIC

Figure 4: Growth rate of Agriculture, Forestry and Fisheries and Its Major Sub-sectors, 2013-2017Q1



Source: CEIC

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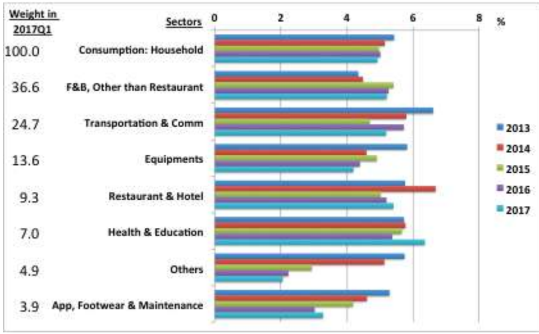
  8.6%
- Trade Surplus (Q2 ’17)
  USD 3.5 billion
- Current Account (Q1 ‘17)
  -1.0%

Decelerating Domestic Consumption Amid Low Inflation

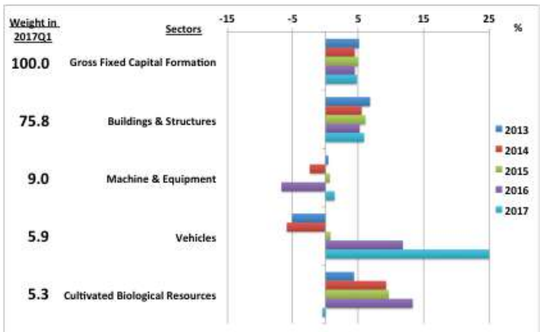
Following slightly weakening data for consumption in the first quarter of 2017, Indonesian economy will remain much reliant on investment and export for the rest of 2017. Given 55% weight of household consumption in GDP, further weakening and unstable consumer confidence should serve as a warning sign if the trend continues to Q3. While weaker consumption growth can be compensated by fiscal stimulus in forms of higher government spending to provide boost in consumer confidence, lower revenue target and statutory budget deficit limit at 3% may limit government’s ability to achieve this year’s growth target. Bank Indonesia will need to look deeper into considering a slight easing in order to restore consumption to its stable path.

Figure 5: Growth rate of Household’s Consumption and its Components, 2013-2017Q1



Source: CEIC

Figure 6: Growth rate of Investment and its Main Components, 2013-2017Q1



Source: CEIC

On the other hand, investment (32% of GDP) is supported mainly by stable growth of buildings and structures. Investment in machines and equipments, needed for increasing production capacity mostly in manufacturing sector, was at its worst last year. Factories had puchased at a record pace of 25% growth per year back in 2011-2012.

Looking deeper into the composition of the consumption by household (see Figure 5), food and beverages are still dominant and grow strongly. Transportation and communication recovered from slowed down growth in 2015, still shows that the household do not cut back on this necessity. Big retailers in malls are struggling, indicated by deep slowing down of apparel and footwear in the last 5 years. Consumers are also still postponing their purchase of household equipments; we should see a slight recovery of this purchase later in the second half of 2017.

Political instability might be one of the culprits. Protests, which were centered on key administrative and commercial centers in Jakarta, disrupted shopping and other commercial activities. Furthermore, the protests called into question the medium- and long-term stability and ultimately prompted middle and affluent classes to delay their durable goods consumption and residential investment activities to a later date.

The increase in electricity tariff would help make this worse. Motor vehicle and motorcycle sales, which declined by -5.7% (y.o.y.) and -10.9% (y.o.y.), respectively, in Q2 2017. On the other hand, consumer confidence index in June 2017 is relatively better compared to the same period last year, which increased from 113.7 to 122.4. However, this index shrank by 3.5 points from May 2017 due to fell in perception of job availability.

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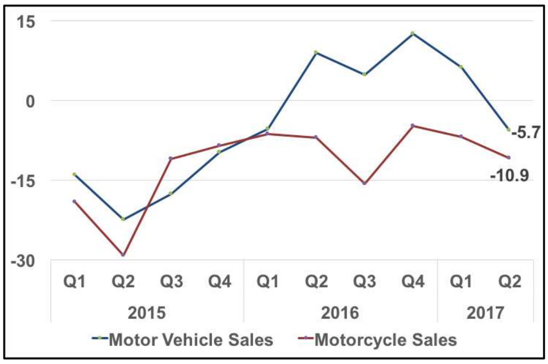
- Current Account (Q1 '17)
  -1.0%

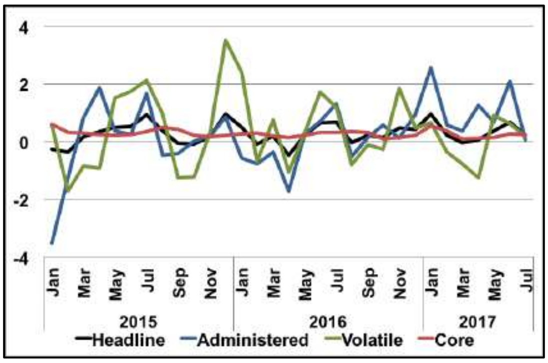
We expect domestic consumption still grows at a slower pace than the overall economy at around 4.9% (y.o.y.) during April to June 2017, and probably will remain flat for the rest of the year mainly due to slow recovery of consumers' confidence.

Figure 7: Motor Vehicle and Motorcycle Sales Growth (y.o.y.)



Source: CEIC

Figure 8: Inflation Rate (mtm)

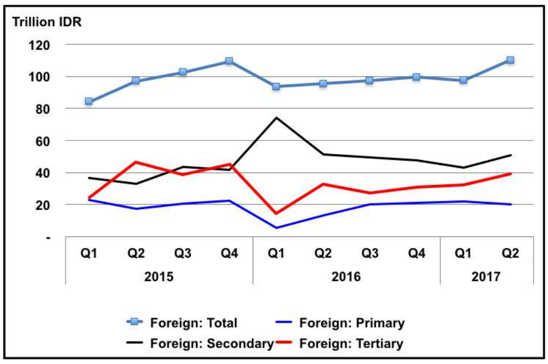


Source: CEIC

Slowdown of domestic consumption caused inflation to be relatively low for the first seven months of 2017. The only major cause of rise in inflation is electricity tariff normalization following cut in energy subsidy. The highest headline inflation occurred in June 2017, during the Eid Mubarak period, which stands at 0.69% (mtm). With inflation currently stands at 0.22% (mtm) and 2.60% (ytd), a relatively low level of inflation for period after Eid Mubarak compared to previous years, we expect Bank Indonesia to lower policy rate in the near future to boost domestic demand and the economy. Considering there are only two major inflation pressure for the rest of 2017, namely Eid Al-Adha and Christmas period, and the government's success in controlling the food price during Ramadan and Eid Mubarak festivity, we forecast inflation to be around 4% in 2017, within Bank Indonesia's target, with bias toward the low end of the estimate as consumption growth may not pick up significantly for the rest of the year

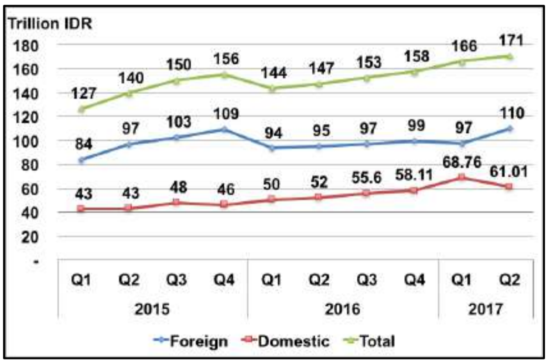
Resilient Investment and Strong Export Performance: Key Growth Drivers for 2017

Figure 9: FDI Realization (Nominal)



Source: CEIC

Figure 10: Foreign and Domestic Investment (Nominal)



Source: CEIC

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Continuing its trend from the last quarter of 2016, we expect gross fixed capital formation to still be the key driver in Q2 2017. While major central banks, such as The Fed, The European Central Bank, and Bank of Japan has started policy rate normalization, Indonesia's better ease of doing business index, which jumped from 106 to 91 due to economic stimuli packages and more efficient bureaucracy, boosted investors' confidence on the pro-business commitment of current administration. This is evident in 15.4% (y.o.y.) increase, in nominal Rupiah term, in foreign investment realization during the second quarter of 2017, even as Rupiah started to appreciate since last year.

Domestic investors also indicated approval of current administration's approach to investment policies by boosting the amount of direct investments. The boost of confidence among domestic investors are particularly prompted by large-scale infrastructure plans and successes of current administration to deliver its promise on infrastructure spending so far. Domestic investment realization recorded an increase of 16.9%, in nominal Rupiah term. Overall, investment realization in Q2 2017 was recorded at IDR 170.9 trillion, up by 15.9% compared to the same quarter last year. During the first semester of 2017, total investment realization was at IDR 337.1 trillion, 49.7% of Indonesia's Investment Coordinating Board (BKPM) 2017 target. Favorable domestic condition and continuous effort by the government to improve investment climate lead us to expect investment realization target to be achieved by the end of this year.

Breaking down the foreign investment realization, the highest growth in Q2 2017 was apparent in primary sector, followed by tertiary sector, as indicated by growth of 50.7% (y.o.y.) and 27.3% (y.o.y.), respectively. On the contrary, secondary sector experienced decline by 0.7% (y.o.y.) in April-June 2017 period.

After several years of decelerating credit growth, credit growth started to show that recovery is underway, with accelerating trend of credit growth since the third quarter of 2016. In Q1 2017, total credit increased by 8.6% (y.o.y.). This increase is caused by rising investment loans (9.7% (y.o.y.) followed by consumer loans and working capital loans by 9.2% (y.o.y.) and 7.6% (y.o.y.), respectively. Increasing investment realization combine with the expected policy rate cut by Bank Indonesia due to controllable inflation lead us to expect that both investment and working capital loans will slightly accelerate for the rest of the year. All of this will further support domestic investment to remain as growth driver for the rest of the year.

We also expect Indonesia's trade balance continued to record surplus in Q2 2017, although with somewhat tapered growth in trade surplus. This has been the case since Q1 2015. Higher increase in export, 9.19% (y.o.y.), than increase in import, 4.92% (y.o.y.), in April-June 2017 led to trade surplus of USD 3.5 billion. Stable commodity prices, around USD 45 per barrel for crude palm oil and around USD 85 per metric ton for coal, helped boost oil and gas export by 19.3% (y.o.y.) in Q2 2017. On the other hand, nonoil and gas export recorded decline by 27.4% (y.o.y.) in Q2 2017. Increase in commodity prices also lead increase in imports, given Indonesia's status as net oil importing nation, widening total current account deficit to 1.0% in Q1 2017

We expect export to further improve, given the strong signals of improved growth around the world (except for US) and receding protectionist rhetoric in world politics. Higher demand from China, Japan, and Eurozone, in particular, will slightly strengthen export performance for the rest of 2017. Soft domestic consumption will, on the other hand, will render imports growth, particularly for final goods and intermediate goods, to be somewhat muted.

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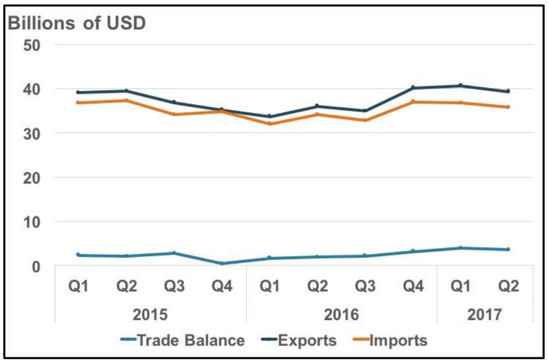
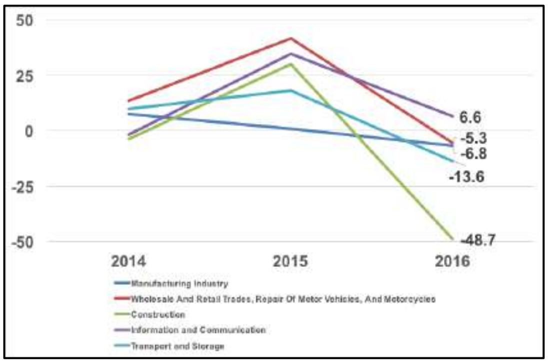
Figure 11: Trade Balance (Nominal)



Source: CEIC

Figure 12: VAT Revenue Growth (PPN *Dalam Negeri*) by Sector



Source: CEIC

Higher Budget Deficit, Increasing Debt

As of 30 June 2017, the overall revenue reached IDR 718.2 trillion, 41.0% of 2017 target, while the overall spending reached IDR 893.3 trillion, 42.9% 2017 target. Looking into tax revenue, the highest revenue came from income tax followed by value added tax (VAT), which currently stands at IDR 314.3 trillion (39.9% of 2017 target) and IDR 192.0 trillion (38.9% of 2017 target), respectively. In 2016, top five sectors that generates VAT revenue (PPN *dalam negeri)* include (1) manufacturing industry, (2) wholesale and retail trades, repair of motor vehicles, and motorcycles, (3) construction, (4) information and communication, and (5) transport and storage, which total for 82.5% of total VAT revenue. However, only VAT revenue from information and communication sector experienced growth in 2016 compared to 2015. VAT Revenue in 2017 has grown by 14% in the first half of the year.

We expect government expenditure to grow lower than the economy in Q2 2017 and the government will increase its spending during the second semester of 2017, like usual.

Recently, Indonesian budget committee approves the government's proposal to lower revenue target and increase spending, which will result in budget deficit of around 2.92% of GDP, shy of 3% GDP statutory limit. Higher budget deficit, which is financed by mix of domestic and foreign debt issuance, is to increase national productivity by funding infrastructure and investing in human capital. However, this deficit spending and state of has recently attracted public scrutiny for the wrong reasons, which we discuss in detail below.

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The Surge of Debt: Much Ado About Nothing

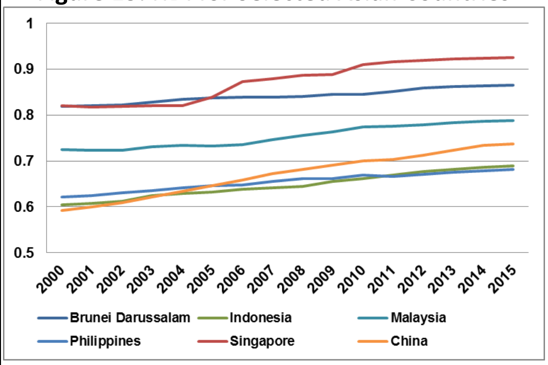
Sudden surge in public unease across social media about the state of the economy and government indebtedness recently may have been caused by lack of general understanding of the nature of sovereign debts, how deficit spending works, and the major difference between today's debt composition and those back in 1998. The unease among lay public is usually centered on the staggering size of nominal sovereign debt owed by central government.

For starter, we should first consider the approach of government on government spending. For almost a good part of two decades following the Asian Financial Crisis in 1998 and Global Financial Crisis in 2008, the Government of Indonesia tried to focus more on maintaining fiscal discipline to avoid any scenario resembling the fiasco back in 1997-1998. Recently, however, there are greater urge to focus to better allocate government spending to promote economic growth through public investment, particularly through infrastructure and social security.

The push on bigger allocation, both in nominal terms and in proportion, on infrastructure, social security, and education is somewhat understandable. Since the 1997 Asian Financial Crisis, various infrastructure projects plans have been idled, making our infrastructure condition uncompetitive with regional peers. According to the data of Logistic Performance Index (LPI) in 2016 from World Bank, Indonesia's Infrastructure Index is placed at 73th with 2.65, which is below the performance of Singapore (6th), Malaysia (40th), Thailand (46th), and even Vietnam (70th). This results in higher logistical cost and reduced competitiveness for businesses located in Indonesia, which do no good to attract export-oriented investments to Indonesia. Improving infrastructure costs a lot of money, part of which should be financed by the government.

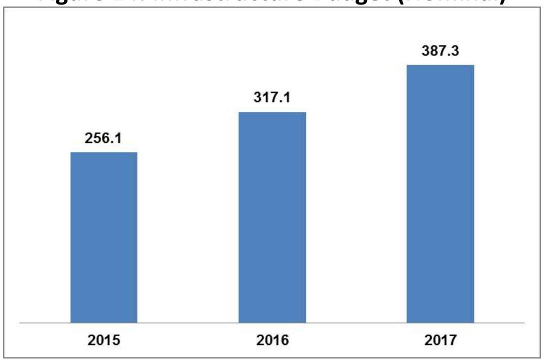
Similar concern can be extended to health and education, where we become less competitive with peers since 1997 as government tried to mend its fiscal health. According to the data from Human Development Report in 2016, Indonesia's Human Development Index (HDI) has been increasing since 2000. However, in comparison to other ASEAN 6 Countries, HDI of Indonesia (0.689 in 2015), placing Indonesia at 113th position out of 188 countries and is lower than Malaysia, Thailand, Brazil, or Mexico. The gap within Indonesia is even more concerning; DKI Jakarta has the highest HDI with 78.99, and the Papua Province has the lowest one with 56.75. Fixing health and education, too, cost money that needs to be sourced from government coffers, as there are many Indonesians who cannot afford health or education.

Figure 13: HDI for Selected Asian Countries



Source: Human Development Report, 2016

Figure 14: Infrastructure Budget (Nominal)



Source: Ministry of Finance, 2017

Financing Long Term Investment on Indonesians: When Smarter Allocation Is Not Enough

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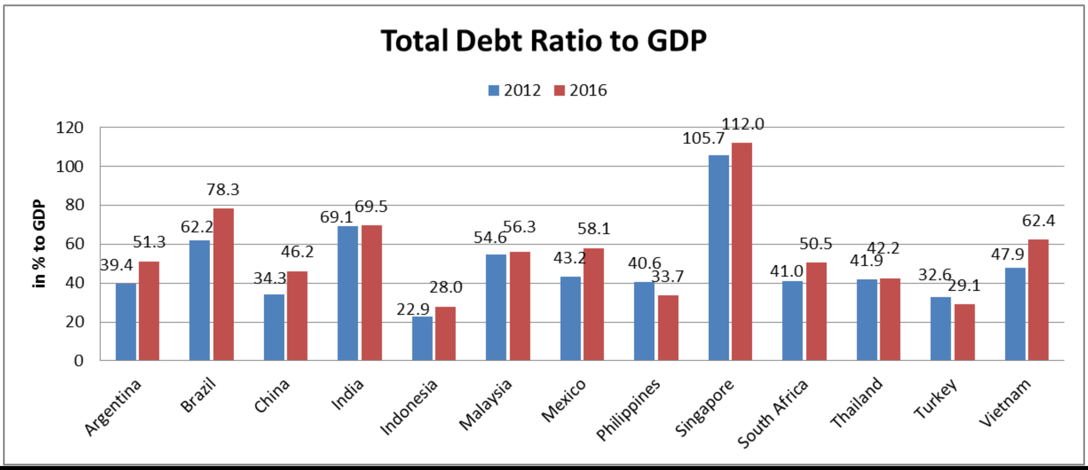
Spending on infrastructure, healthcare, and education are productive investment on Indonesians; those expenses that are incurred today will improve ability of Indonesians to work more productively and enjoy better quality of life in the future. To finance the prospect of better future, however, are costly; the options are either to divert government spending from other posts, levy more taxes, or to spend more than what government receive in taxes and borrow even more to finance the gap.

One of the first measures that were taken by Jokowi administration is to divert spending from more wasteful posts, particularly energy subsidy. This can be seen by sharp decrease (66.2%) in energy subsidy since 2014 to just IDR 77.3 trillion in 2017. This allowed government to increase spending on other posts, such as infrastructure, which has seen a massive rise of 123.4% to IDR 387.3 trillion. The share of infrastructure spending on APBN has also risen from 9.8% of total spending in 2014 to 18.6% of total expenditures in APBN 2017.

Lower energy subsidy, nevertheless, is not enough to finance more infrastructure spending while keeping the budget balanced. Even as government insisted on more infrastructure, healthcare, and education spending, government revenue could not and still cannot keep up with the surge in spending. Collapse in energy and commodity prices have hit taxes and non-taxes revenue very hard. Combined with slowdown of export and eventually domestic consumption as the result of low commodity prices, has also meant that income taxes and VAT cannot make up for the reduction in resources royalty and oil and gas income taxes. Relatively poor ability of government to collect taxes, particularly given the size of informal economy, exacerbate the revenue shortfall. With increase in tax rate being out of the question, given the relatively fragile state of purchasing power growth, the only feasible route to finance infrastructure spending is through higher deficit.

How Safe is Our Debt Position?

While the planned deficit is very close with statutory deficit limit of 3% of GDP and the seemingly daunting nominal size of government debt, amounting to IDR 3.706,52 trillion in June 2017, the underlying structure of Indonesia sovereign debts is still very good and should not be a source of concern. Total Debt to GDP Ratio, measures the ratio of total outstanding external debt at the end of a year to annual GDP for given year, is around 28% in 2016, which is very manageable and still far below the prescribed limit of 60% GDP that is adopted by Indonesia's Act No 17 Year 2000 and Maastricht Treaty. Current level is also a far cry from the height in 1999, where Indonesia's Debt-to-GDP ratio peaked at 85.4%. External comparison also shows that current level is still very decent, particularly when compared with countries such as Japan (239%), United States (107%), Vietnam (62%), or Malaysia (56%).



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Another measure that should bring more peace of mind on the issue of debt sustainability is that majority of Indonesia's debt are Rupiah-denominated. By June 2017, IDR 2,979.50 trillion of debt is denominated in Rupiah, equivalent to 59% of total debt. The strength of our fiscal position is further reaffirmed by the latest rating upgrade by Standard & Poor's, which means that Indonesia's sovereign debts are fully rated as investment grade from all three major global rating agencies.

Combined with government's plan to pursue infrastructure and other productive outlays, government's decision to finance spending through debt should not be seen as worrying. This decision is not unlike how corporations and individuals try to increase their productivity (by investing in equipment, new factories, or expansion) or to improve quality of life (buying houses or vehicles) through debts. Rather than something that burdens the economy, borrowing more money to finance productive spending enables businesses to expand to new area, lower logistical cost, and improve their profitability, which will pay for the debt through increased tax revenue.

What to Actually Be Concerned About

While Indonesia's debt structure should not be source of concern for the general public, the possible crowding-out effect of increased government spending should be further scrutinized. To illustrate the crowding-out effect better, we should keep in mind that there are only finite amount of money that individuals do not consume and want to put into savings. Those savings are put in either bonds or banks, which ultimately will be used to finance private businesses or government deficit. If the pool of savings remains constant, increased government deficit will eventually mean that businesses will only have fewer amount of money to borrow from. This means that for every increase in government deficit financed through debt, there is equivalent decrease in amount of money that can be used to finance private investment by corporations.

This effect is already apparent through the tepid increase in credit growth to non-financial corporate borrowers and rapid increase in Rupiah-denominated government securities. The decrease in available pool of financing to private corporate borrowers, private investments and future productive capacity of private sector will not increase as much, which will then cancel out possible expansionary effect of government spending on infrastructure. This should serve as cautionary tale for government to more wisely spend money, particularly to prioritize economically beneficial projects and less on white-elephant, showcase projects.